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NATIONAL GRID TRANSCO – POTENTIAL SALE OF GAS DISTRIBUTION NETWORK BUSINESSES - OFFTAKE ARRANGEMENTS
Regulatory Impact Assessment June 2004

Dear Sonia

RWE Innogy welcomes the opportunity to respond to Ofgem's Regulatory Impact Assessment (RIA) on the Offtake Arrangements from the National Transmission System (NTS) and the Distribution Networks (DN). These comments incorporate the views of RWE Trading and RWE Innogy's retail business, npower.

In general, we agree that the offtake arrangements need to establish a framework to address concerns about potential discrimination between DNs, promote an economic and efficient level of investment, maintain security of supply and not adversely affect competition. The offtake arrangements should, in principle, ensure that the retained and independent DNs are treated equally and downstream market distortions are minimised. Although it argues for fundamental changes in some areas, the RIA does not set out a compelling case for change and we are concerned that increased complexity will lead to increased costs for little or no additional benefit. We believe that existing arrangements, modified to remain consistent with divested industry structure, should be retained. We can see no need or justification for undertaking radical reforms and they are certainly not required in the context of facilitating a DN sale.

At the NTS/DN interface, it is possible to identify operator-to-operator activities and operator-to-shipper activities. As shippers, our principal concern is that any new arrangements do not materially affect current capacity setting and booking processes and that current levels of flexibility are maintained. Beyond this capacity booking role, largely driven by their end-users' requirements, it is not clear that there additional benefit from involving shippers at what is essentially an operator-to-operator interface. Shippers will have a more significant role in NTS and DN interruption, which is a related aspect of offtake arrangements, covered under a separate RIA.

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Capacity Definition and Booking

Ofgem endorsed an approach characterised by requiring clarity of roles and responsibilities for system operators on their own networks, in the earlier Roles and Responsibilities RIA. It is unclear why Ofgem should now put forward and support options that dilute and blur responsibility for meeting network security standards.

Having been developed as an integrated network, there will continue to be a significant level of interdependence between the NTS and DN pipeline systems both in terms of day to day system operations and in meeting longer-term security standards. We believe that both the DNs and NTS should continue to be obliged to develop and maintain efficient and economic pipeline systems and face statutory obligations in relation to security of supply. Where the transmission and distribution networks are under separate ownership, there is a requirement to ensure that the offtake code allows each network owner/operator to comply with their obligations.

We would make the following observations on each of the options:

Option 1: Transco's initial proposal
This is the simplest option and represents least change. We agree that there is potential for disputes under this option as the NTS retains the primary 1-in-20 obligation, which may result in DNs getting less capacity than requested. However, providing an appropriate dispute resolution mechanism is introduced, which need not involve Ofgem, we are not against this approach.

Option 2: DN booking model
This option also has merit, although more detail on the proposed incentive parameters for DN capacity booking is required. In the absence of a 1-in-20 obligation, incentives for NTS investment need to be consistent with those for DN and a collaborative approach adopted, to avoid disputes. Of the two alternatives, we would support 2A.

Option 3: Shipper and DN booking model
This option dilutes responsibilities and raises a number of questions regarding the treatment of top-up capacity booking costs. We do not believe that shippers will be able to meet the implicit long-term booking requirement and do not support this option.

Option 4: Shipper booking model
This option represents the most fundamental change to the current arrangements, which we believe to be unworkable and unnecessary in the context of a DN sale. Signals at most offtake points would be short-term and it is unlikely that shippers, even in aggregate, will provide meaningful signals on investment timescales. Any inefficiency in shipper bookings would lead to distortion of retail markets, through distributional effects, and could create a barrier to entry. We are not convinced that liquid secondary markets in exit capacity will develop or that "exchange rates" between exit zones can realistically be created. In our opinion secondary markets will not provide adequate protection and security of supply under this option will be seriously undermined. Furthermore, we believe that the costs of the allocation, capacity determination and management processes implied by the option have been significantly understated. We do not support this option.

Responsibility for investing to meet a network security standard logically sits with the network operator, rather than shippers. The competitive supply market means that shippers operate with less certainty about future capacity requirements and, in our view, will be unable to provide meaningful signals up to 5 years out. If forced to book speculatively and carry this booking risk, shippers will face higher costs to serve, with consequent effects on retail prices. Without the ability to reflect diversity in their individual bookings, it is hard to see how aggregate shipper bookings will lead to optimal capacity provision. Shipper portfolio bookings will be one input available to the network operator, who is able to utilise detailed network models and a consideration of wider macro-economic issues that are likely to influence future capacity requirements.

Diurnal Storage and Operational Flows

From our perspective, diurnal storage is an operator-to-operator issue. Shippers arrange for gas to be conveyed on an entry-exit basis to end-users and are less concerned about how physical gas flows are managed. As this “secondary” capacity is a function of the level of primary capacity and prevailing system dynamics, presumably its costs are included, implicitly if not explicitly, in transportation tariffs. It is not clear whether separately charging for them is practicable or provides any better targeting of costs.

By adopting a definition based around primary and secondary capacity, Ofgem has included operational flows in its analysis. The RIA is unclear as to whether the proposal is for a standard service with added services and what constitutes the standard. We strongly believe that any flexibility provided for in existing offtake-related agreements, such as NExAs, should be retained. In practice, access to this flexibility only becomes a problem when the system is constrained. To introduce complex arrangements to deal with these relatively infrequent events does not appear to be justified.

Ofgem argue that a commercially based approach has a positive benefit over an administered approach. This claimed benefit arises principally due to more economic and efficient network development and operation. However, this is on the assumption that markets will develop to allow these services to be priced efficiently. On the evidence of secondary entry capacity trading, we remain to be convinced that these markets will emerge. A further consequence would be that the claimed lower gas or electricity balancing charges would not necessarily arise.

Business Separation

The preliminary RIAs undertaken to date suggest that there could be net benefits to customers from the sale of one or more DNs, arising from improved operational efficiency and introducing comparative price regulation between the DNs. Independently owned and managed gas distribution networks can provide scope for greater efficiencies, as their management seeks to innovate. We believe that whilst the retained DNs and the NTS have a single ultimate shareholder, their aligned commercial incentives will constrain the extent that the full benefits of comparative regulation are achieved. We therefore support Option 3 Legal and Structural Separation.

Although NGT has argued that legal separation may affect its financial position and increase its costs, we are not in a position to assess or quantify this. In the absence of any evidence to the contrary, we share Ofgem’s view that these additional costs will not arise and, in any case, should not be passed on to customers.

Operator-to-operator arrangements should lead to optimal network management and efficient capacity provision. This clearly calls for a collaborative approach and the alignment of incentives between operators. It is reasonable to assume that operators' commercial and statutory incentives will by and large be similar, particularly where they share common Licences and Network Codes. It is harder to understand the extent to which these will overlap with shippers, who will have different drivers in respect of exit capacity booking. We support developing offtake arrangements based around the following high-level principles: either option 1 or 2A for the allocation of NTS exit capacity; an administered approach to the allocation of diurnal storage and retention of existing flexibility; and legal and structural separation of the NTS and retained DN businesses.

We hope that these comments are helpful and would be happy to discuss these matters further.

Yours sincerely

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